

## Rearranging Deck Chairs on the *Titanic*: Policy Responses to the Asian Financial Crisis and Challenges to Governance

JOEL R. CAMPBELL  
MIYAZAKI INTERNATIONAL COLLEGE

The end comes unexpectedly. The president makes a simple, low-key announcement in May, that after thirty-three years as undisputed head of his nation, he is stepping down and handing power to his designated successor. His country has been in turmoil the previous three months, with widespread rioting throughout the country, and with widespread discontent at a continuing pattern of cronyism, nepotism, and political dominance of the military and local elites. The regime has gained what legitimacy it has from a growing economy and generally rising standards of living, and the political stability of the nation depends on suppression of ethnic conflict. With the sudden onset of the financial crisis in 1997, what little legitimacy is left has evaporated. First, the nation is unable to pay its foreign obligations, threatening business and throwing thousands out of work. Then, to make matters worse, an austerity program ordered by the International Monetary Fund (IMF) and supported by the U.S. as a condition for bailing out the country makes living costs unbearable for millions, as the government cuts subsidies for key services and commodities. The final straw is a considerable hike in fuel and electricity charges. Massive demonstrations planned at the national legislature loom, with the military determined to prevent them; the aura of China's Tiananmen hangs in the air. Only the president's shocking last-minute decision to stand down prevents a bloodbath.<sup>1</sup>

The resignation of President Suharto of Indonesia in 1998 was merely the last of the major dominos that tumbled in the wake of the 1997–1998 Asian financial crisis. The calamity that began with an ill-considered attempt by the Thai government to defend the value of its currency, the baht, in July 1997 had caused social upheaval and sweeping economic and political change in every country it touched, including Russia and Brazil. This was not merely an economic crisis, but a political earthquake that also swallowed up Prime Minister Chevalit of Thailand and President Kim Young Sam of South Korea, constituted

---

The author is an assistant professor of political science and economics at Miyazaki International College in Miyazaki, Japan. He welcomes comments and correspondence at [jcampbel@miyazaki-mic.ac.jp](mailto:jcampbel@miyazaki-mic.ac.jp).

a key element in the retirement of Fidel Ramos and election of Jose Estrada as president of the Philippines, and played a major role in the ouster of Deputy Prime Minister Anwar Ibrahim by the ruling party in Malaysia. The parallel softening of the Japanese economy led to disastrous Diet upper house election losses in Japan, and the subsequent resignation of Prime Minister Ryutaro Hashimoto. In supposedly rock-solid China, rising unemployment and falling growth indicators helped fuel rumors that Premier Zhu Rongji would be replaced in 1998. Even in the booming U.S., concerns about the stability of the global economy contributed to the lackluster performance of the Republicans in the 1998 mid-term elections.

As the major event in East Asia during the 1990s, the crisis is a watershed in Asia's economic and political development, as well as the U.S.-led postwar international financial system. Before 1997, the region's rapid development was held up as a model for the rest of the world; afterward, that model was widely ridiculed, if not condemned, for creating the conditions that fostered the financial meltdown. Currently, conditions are perceived to have returned to normal in most of the affected countries, save Indonesia, and so a curious complacency has returned to the region. What in late 1997 appeared to be the mother of all financial disasters now seems to many as just a kind of pothole in the highway to prosperity. Is Asia out of the woods yet, and is the nightmare over?

A useful counter to this postcrisis euphoria is a meditation on perhaps the most overworked metaphor of the twentieth century, the ill-fated ocean liner *Titanic*. As it lay stricken in the North Atlantic, shortly after sideswiping an iceberg on a calm, frigid night in April 1912, there was a growing sense of unease. But surely nothing is wrong, thought many of the passengers. The ship is solid, has made no violent movements since it stopped, and the ship's crew has assured us that nothing is fundamentally wrong. Some passengers even went back to sleep after a short time; the fates of some of them are unknown. Unfortunately for the confident-appearing crew and trusting passengers, the ship sank in less than three hours. Is the world now making the same mistake as those sleepy passengers, or is the ship safe? This paper contends that the ship of Asian finance is anything but safe, and though the bulkheads have been temporarily shored up, the bumping of even a small iceberg could cause them to give way again. The next few years will determine whether the good ship *Asian Economy*—along with the American and Japanese ships that depend on it—makes it safely to port.

The American and Japanese responses to the crisis, along with the efforts of the American-dominated IMF, were perhaps the most disappointing features of the crisis. Partly in pursuit of its liberal free-market program (commonly called the "Washington Consensus"), the U.S. shifted from active intervention to passivity in international finance. At the same time, the Clinton administration pressured Asian states to give up their hitherto relatively effective financial management, and liberalize financial markets; this led directly to the combination of long-term domestic lending and short-term international borrowing that

proved so deadly across East Asia in 1997. When the disaster hit, Washington's reaction was both halting and limited. Much more financially exposed than the Americans in Asia, Japan attempted to keep its neighbors liquid throughout the crisis, but its failure to deal forthrightly and fully with its own economic and financial difficulties meant it was continually undermining the very confidence in the region's economy it was trying to rebuild. The U.S. and Japanese failures left the IMF to carry out most of the cleanup. Largely relying on its Latin American experience, the Fund probably overreacted to the events of 1997, and so needlessly delayed the recovery.

U.S.-centered scholarship points out the general causes of the crisis and outlines the basic course of events in 1997–1998, but disagrees about whether the IMF's bailout and mandated reforms were the proper response to the crisis, whether things have changed fundamentally since then, and whether the world is in danger of another monetary calamity. The Asian financial crisis was a body blow to the putative postwar Asian model of development, centered on the developmental state, export-oriented industrialization, and tight connections between state and business. During the crisis, popular desperation and political expediency led to serious talk about reform of the political-economic nexus in many East Asian countries. However, the postcrisis climate has turned distinctly cautious, if not conservative, and much of the reform has been incomplete (if not stillborn). This article examines the varying policy responses to the Asian financial crisis, focusing on the countries hit hardest by the crisis, Thailand, Indonesia, and South Korea. It finds that while Thailand attempted the most thoroughgoing economic restructuring, and Indonesia carried out the most sweeping political reforms, all of the major East Asian economies are still in serious danger of another financial crisis. The paper also examines the efforts of Japan, Taiwan, and China—major players who were not directly hit by the crisis, but who nonetheless face major economic transitions—to come to grips with the effects of the crisis.

### **The IMF Rescue Packages**

Even in Asia in the pre-1997 boom, economic and political development were not easy tasks. A developing nation's people are relatively poor, and tend to have large families. To stay ahead of population growth, countries must achieve heady economic growth, but often the only thing that can generate that kind of growth is exporting. To build up export industries, countries have to import capital equipment and raw materials, and often have to rely on foreign capital. So, the path to development is ever dangerous: economic growth and exports must surpass population and imports, or the country risks a current account deficit and difficulties meeting international obligations. In recent years, developing countries have been urged to liberalize their economies, in order to take advantage of

global production and services, and most Latin American and Asian countries have felt they had no choice but to follow the advice. But it sometimes seems to be a global case of “damned if you do, damned if you don’t.” A case in point is Mexico, which completely liberalized its economy and opened its borders to the U.S. via the North American Free Trade Agreement (NAFTA), yet still faced a serious financial crisis in December 1994, caused by a combination of “local capital flight” and pulling of funds by “disenchanted American investors.” Though largely forgotten in the wake of the Asian crisis, that Yuletide season the world financial system briefly faced a meltdown that was only averted when the Clinton administration cobbled together a \$50 billion rescue fund.<sup>2</sup>

American analysis of the IMF role in containing the crisis of 1997–1998 has few nuances: observers either strongly support or oppose the IMF packages arranged to help the various financially distressed countries in 1997 and 1998. The official IMF account of its actions defends the Fund’s forcing of comprehensive reforms on the Asian economies as necessary to remove conditions that could cause recurrence of their financial problems, and suggests that a financial crisis is perhaps the only time to accomplish meaningful economic policy change. It stresses that poor governance was the critical variable leading to the crisis, and the need for an “immediate effort to reestablish confidence” involving four elements: (1) “temporary tightening of monetary policy” to deal with currency depreciation; (2) dealing with weaknesses in the financial system; (3) structural reforms of “features of the economy that had become impediments to growth,” which included monopolies, trade restrictions, and nontransparent business practices; and (4) control of fiscal spending, yet providing sufficient money for financial restructuring and provision of social safety nets. The IMF adds that the structural reforms were “at the heart” of all its bailout programs, and the reform of financial systems was a key feature of all the programs; they involved closing nonviable financial institutions, injecting capital into troubled banks, “close supervision” of problem institutions, and increased opportunities for foreign participation in financial sectors.<sup>3</sup>

IMF critics assert that the bailout packages caused as much harm as they did good. First, various critics see IMF rescues of tottering economies as a kind of global moral hazard, since the countries got off with only relatively light economic punishment for their financial sins.<sup>4</sup> Such treatment eventually might effectively encourage them to revert to the very practices that brought on their difficulties in 1997. Second, the massive scale of the IMF bailouts, with several countries being helped at the same time, meant that the organization had stepped far beyond its original postwar role of being a lender of last resort to countries with short-term balance of payments difficulties. Third, the stringent conditions attached to the bailout packages were more relevant to the state-run developmental cases of Latin American and Africa than the largely privately held economies of Asia, and so nearly strangled Asian recovery in its crib. Specifically, the sudden spike in interest rates caused severe problems for businesses

and helped push many small and medium enterprises (SMEs) into bankruptcy, especially in Thailand and Indonesia, but also in South Korea. This, in turn, contributed to the sharp rise in unemployment across East Asia during the crisis period. Moreover, the structural reforms mandated by the rescue packages often addressed parts of the economy or economic policies that had not been directly responsible for bringing on the crisis. Fourth are critiques centered on the supposedly secretive nature of IMF decision making, the Fund's frequent missteps, and its invasion of areas that are more properly the province of state policymakers.<sup>5</sup>

Sachs and Woo go further than most critics, suggesting that "draconian" IMF programs helped create the contagion that dragged most of Asia under. The cause of the crisis was neither bad government policies nor depreciation of the currency, they assert. Instead, it was the ill-considered efforts of the governments to deplete their foreign reserves in an attempt to defend the value of the currencies. This combined with fear engendered by the largely irrelevant IMF reform programs to effect a "full-fledged financial panic."<sup>6</sup>

The argument over the IMF's role is actually fairly easy to sort out. First, the rescue of the Asian economies was completely necessary, and, moral hazard or not, defaulting on their debts in 1997 would have had incalculable effects on the world economy. After all, the East Asian economy now accounts for perhaps about a quarter of world trade, and South Korea (recipient of the largest bailout) has become the eleventh largest economy. Second, the IMF has definitely become more important than ever, and that role will not lessen in the coming years. Nonetheless, a more open, democratic, accountable organization would increase its legitimacy. If the IMF focused on its original mandate of helping countries with short-term balance of payments problems, and thus avoided imposition of sweeping reforms, the pain of coping with a financial panic could be greatly mitigated. Third, the creation of regional mini-IMFs, as proposed by Japan's government, would allow Asians, Latin Americans, or Russians to solve many of their own problems before they grab international headlines, and free the Fund to concentrate on the most important situations. Such mini-IMFs could work toward greater openness and reform of all economies in their regions, but would be able to do so in a more long-term, proactive, cooperative manner. More on recommendations can be found in a later section of this article.

The conditions imposed on East Asia were definitely too strict, and probably made the region's recoveries much slower and more painful than demanded by the situation in mid-1997. Many of the mandated reforms may have appeared to be necessary from a long-term perspective, but ended up being quite harmful from a short-term view (e.g., use of high interest rates at the height of the crisis). In future, the IMF must try to avoid one-size-fits-all solutions that it believes have worked in Latin America, but do not necessarily apply elsewhere. Even in Latin America, the drastic nature of mandated reforms contributed to the roller-coaster economic pattern of the 1970s and 1980s. IMF and World Bank conditionality is responsible for a large share of the economic hardship facing

contemporary Africa, and it would be a tragedy of immense proportions if the Bretton Woods institutions' mistakes were repeated elsewhere.

### **American and Japanese Policy Responses**

Western Europe's immediate postwar experience shows a better way to economic development and cooperation. After World War II, most European economies were functioning at prewar levels, and the task of reconstruction turned out to be much larger than originally envisioned. Britain and France were both exhausted from the war, and neither could exert effective leadership over the continent. Western Germany was under military occupation, and her economy was barely functioning. By 1947, American policymakers reached a bipartisan consensus on the need for Western European economic integration and massive aid to the continent. Thus was born the Marshall Plan (amounting to about \$60 billion in current money), perhaps one of the most successful foreign economic initiatives undertaken by the U.S. government, and a program credited with jump-starting the recovery of the region and launching a two-decade period of strong growth.<sup>7</sup>

The Marshall Plan was an American recognition of the importance of a proactive, internationalist foreign policy, and the need to recycle gold and dollars that flowed to the U.S. It was also the first major step in U.S. postwar hegemonic leadership. Subsequently, America was called upon to take the lead in handling various economic crises during the Cold War era. For the developed economies, the U.S. acted as an economic locomotive, several times lifting the world out of recessions. For developing nations, the U.S. orchestrated various rescue packages, most notably the IMF programs in Latin America during the early 1980s and the Brady bonds that helped those same Latin countries eliminate much of that debt and restructure in the late 1980s.<sup>8</sup>

Curiously, America has become relatively passive in the 1990s, less willing to shoulder the burden for economic adjustment. The U.S. Federal Reserve kept interest rates fairly high to fight inflation in the midst of the world recession of 1991–1992, and so, partly as a result, the U.S. did not provide its usual locomotive function. When the Asian financial crisis hit, U.S. policymakers appeared oddly detached during much of the early going. Eventually, the Treasury Department and Federal Reserve turned their full attention to Asia, and worked behind the scenes to put the various IMF packages together, while U.S. officials and President Clinton put pressure on the Suharto regime to accept the Fund's conditions for supplying the bailouts. The U.S. government also took various unilateral measures to help its Asian friends. These included \$1 billion in short-term financing from the Export-Import Bank for both Indonesia and Thailand, \$70 million in humanitarian assistance to Indonesia, temporary assistance of various kinds for Asian students studying in the U.S., \$400 million for two Thai electric power projects, \$435 million in humanitarian and recovery assistance from

USAID, and a comprehensive information program on the financial crisis by the Commerce Department.<sup>9</sup>

Curiously, the most active component of the American response to the crisis came not from the Treasury Department or the Clinton White House but from the Federal Reserve Board (FRB) under Chairman Alan Greenspan. To bolster worried financial markets, America's quasi-central bank lowered interest rates as the crisis deepened, and kept them relatively stable during the recovery. Greenspan also helped arrange the private rescue of one of the largest U.S. hedge funds. As the world's de facto financial manager, Greenspan probably did more than anyone to restore confidence in the world economy. However, the FRB is not really in any position to act as a central bank for the world, and will only be able to play a helpful role in future crises if economic conditions are favorable within the U.S.

Analyses of U.S. and Japanese official responses to the crisis also differ markedly. Much media and think tank commentary, while noting early U.S. detachment from the developing catastrophe, has praised U.S. employment of just the right balance of economic support and prodding for reform needed to allow the world to scrape by and avoid a financial meltdown. They have also lauded the Americans for helping to organize all of the IMF packages that saved the Asian, Russian, and Brazilian economies in 1997–1998. Krause, for instance, criticizes U.S. slowness to act in the early stages of the crisis, but commends later U.S. efforts, especially in South Korea.

Other commentators lay much of the blame for the crisis, or at least for the severity of it, at Washington's doorstep. First, they castigate successive U.S. administrations for helping foster the tight state-business relationships and authoritarian capitalist systems that created the atmosphere of moral hazard, nontransparency, and lax oversight surrounding the crisis. Second, by pushing the "Washington Consensus" (liberation of trade and finance, cracking down on "overleveraged" businesses and banks, and avoidance of capital controls), the U.S. directly abetted the swift, massive flows of money into the region that proved so injurious. Sharrock suggests that the U.S. is responsible for difficult economic conditions in the region. Successive administrations helped create the strong state-business linkages known as the Asian Model, he says; then the Clinton administration branded them as the chief cause of the crisis, and pushed the Washington Consensus as the only path to development. Sharrock suggests that these paradoxical policy stances have isolated America politically and economically, and have heightened the impact of the crisis on the U.S., as they have made it more difficult for Asians to buy American goods and services, thus increasing American trade deficits.<sup>10</sup> Galbraith agrees that the Washington Consensus has "undermined economic prospects for many millions of the world's poorest people" and argues that the state-led alternative approaches used in Korea and China are more appropriate for the developing world.<sup>11</sup>

These latter criticisms partially dovetail with more radical attacks on the U.S.-

led international trade regime centering on the World Trade Organization (WTO). The large public demonstrations against the WTO in Seattle in 1999 and against the IMF and World Bank in Washington in 2000 did not directly relate to the financial crises of 1997–1998, yet were reminders of widespread unease about economic globalization—and trade liberalization and financial instability are two key facets of globalization. Critiques of both the WTO and IMF focus on supposedly closed, nondemocratic decision making, and destruction of local economies and cultures for the benefit of large corporate interests. Actually, neither of these aspects of globalization has been handled well by the U.S. or the major international organizations, and this has contributed greatly to the current unease.

Japan's role in the crisis was both more limited and more roundly criticized. Like the U.S., Japan took some time to react to the crisis, probably more because of its own chronic economic stagnation and political sclerosis than any desire to avoid involvement. Unlike the U.S., Japanese investors and producers were greatly exposed in Asia and so could not avoid involvement in the crisis. Various commentators partly blamed the East Asian economic slowdown that preceded the crisis on the sluggish Japanese economy, which formerly had absorbed a large amount of Asian exports. However, Japan did provide various funds to help ease the crisis, continued efforts—though only partly successfully—to stimulate its own economy, and most famously proposed creation of an Asian regional IMF-style organization. The latter proposal, while attracting much attention, was quickly shot down by the U.S.

However, much more attention was paid to the state of Japan's economy, which accounts for about two-thirds of the total East Asian economy. The chief problem of the 1990s was a classic Keynesian liquidity trap, played out in slow motion. No matter how much money the government spent to boost the economy, mainly through construction-related pump-priming, there has been little direct economic benefit, and consumers have refused to increase spending due to basic insecurity. For instance, in March 1998 Japan announced a \$127 billion infrastructure stimulus package. Like several packages before and after, it had only a marginal effect on growth (perhaps one percent or so), while helping balloon the nation's fiscal debt.<sup>12</sup>

While it is true that actions by the U.S. and Japan proved instrumental in arresting the Asian financial crisis, neither nation's leadership felt called upon to do more than a bare minimum to address the disaster, and both countries could have made greater efforts. Japan could have given much more direct assistance to its Asian neighbors, beginning with complete liberalization and promotion of imports from Asian countries. The U.S. could have used its dominant voice in the IMF to argue for looser initial conditions attached to the bailout packages, and this could have helped countries such as Thailand and Indonesia recover much faster. It could also have eased up on its insistence on greater liberalization, which created conditions that encouraged overborrowing in the run-up to



1997. More careful joint monitoring of financial liberalization in the years preceding the crisis could have prevented much of the short-term international borrowing/long-term domestic lending syndrome that magnified the dimensions of the disaster. An early coordinated *Nichibei* response, and perhaps American concession to the Japanese idea of the regional "AMF," could have done much to halt the contagion effects of the crisis. A thoroughly thought out joint strategy for handling the political-cum-economic meltdown in Indonesia could have eased the post-Suharto transition.

As long as successive U.S. administrations remain wedded to the Washington Consensus, and Japanese politicians remain frozen in an early postwar domestic-oriented, Keynesian mode, both nations will have great difficulty formulating or adopting new global financial policy approaches. It is time for a major rethink of relations between Japan and America, and of their international financial policies. Short of a catalyst similar to the Great Depression or the early postwar readjustment, however, one cannot expect either side to take the initiative.

### Debate on the Causes of the Crisis

The East Asian crisis of 1997–1998 was by no means the world's first major financial disaster. Unfortunately, such crises are a "hardy perennial" of the modern world economy and have been a feature of capitalist economies since the late Middle Ages. National financial breakdowns began occurring with increasing frequency in the nineteenth century, and the crisis of 1929 led to the Great Depression, the greatest economic upheaval of the twentieth century. Kindleberger, using a model formulated by Minsky, suggests that there is a common "anatomy" to such crises: an external shock of some kind leads to "overtrading" and various financial scams, and government may contribute to general overheating through monetary expansion. During the "critical stage," states can either tamp down speculative fires or inadvertently encourage them to rage. Runaway speculative bubbles can be either domestic or internationally centered, but at some point they usually burst and subsequently can be either managed or left to "burn out." If conditions threaten worldwide depression, a "lender of last resort" may step in to stabilize conditions.<sup>13</sup>

Kindleberger and other (mainly American) chroniclers of financial panics remind us that there was really not much that was unique about the Asian crisis. Even in the slower-paced nineteenth century, large sums of money could be transferred across borders quickly, and fortunes could be made or nations ruined overnight. What is perhaps unique about the Asian crisis is, first, that it began in a relatively small country thought to have had a fairly sound economy and quickly spread to larger neighboring countries. Second, the degree of state involvement in private financial decision making, coupled with the sudden state-imposed liberalization of financial sectors throughout the region, undoubtedly

amplified the crisis and created a public-private symbiosis that made solution of the crisis more difficult (previous crises in Latin America primarily concerned bad governmental decision making related to state-controlled banks and state-owned enterprises).

There is growing general agreement among scholars on the major causes of the Asian financial crisis. At first, much blame was placed on the operations of international financial markets, which seemingly exacerbated the crisis by facilitating massive shifts of capital out of troubled countries. There was widespread agreement with—or at least grudging acceptance of—Malaysian Prime Minister Mahathir Mohammed's attacks on international speculators and hedge funds for ruining the Asian economies in pursuit of speculative gains, though economic liberals mounted a strong counterattack. Many of the more sensational press accounts of the crisis focused on the massive flows of capital into the region leading up to July 1997, and the cataclysmic reverse flow out of East Asia as the "Asian flu" spread from country to country.<sup>14</sup> Henderson's journalistic tour of the crisis as it developed, for instance, concentrates primarily on the drama of international currency trade's impacts on the region.<sup>15</sup>

As the initial crisis panic died down, though, the focus of discussion gradually shifted to domestic roots of the crisis. While many recognize that post-Bretton Woods changes in international finance and foreign exchange have created a fundamentally altered environment that should be scrutinized—and perhaps reformed—both international and local commentators now generally place the lion's share of both blame for the contagion and onus for change on local actors. These supposed domestic causes center on governance issues; tight connections between budding industrial, construction, and real estate businesses; poor supervision of loan practices of banks and other financial institutions; the moral hazard created by government guarantees for borrowing by state-favored export-oriented or crony capitalist firms; and, perhaps most importantly, the unwise use of short-term foreign borrowing to support long-term domestic lending.<sup>16</sup>

Various scholars have provided comprehensive midcrisis or postcrisis guides to the primarily domestic economic policy-related factors that triggered the tumult. Krause, for example, suggests that, while "it is hard to trigger a financial debacle," analysis should focus on four general causes of the Asian crisis: (1) a "significantly overvalued" currency (the "technical condition"); (2) a rapid accumulation of short-term debt; (3) simultaneous "disarray of public finances" and "fragile private domestic financial institutions"; and (4) "political uncertainty," that is, economic policies becoming unpredictable for economic actors.<sup>17</sup> Similarly, Goldstein selects three outstanding factors in development of the crisis: (1) "financial sector weaknesses cum easy global liquidity conditions"; (2) large and growing current account deficits in the years leading up to the crisis; and (3) the contagion effect, unusual to this crisis, as the problems of one small country (Thailand) spread to surrounding nations and eventually affected South Korea.<sup>18</sup> Cronin finds six causes for the crisis: (1) "excessive reliance" on short-term for-

eign borrowing by businesses and banks; (2) “overinvestment in real estate”; (3) “inadequate supervision” of financial operations; (4) “politically influenced allocations” of loans; (5) “overly expansive” fiscal and macroeconomic policymaking; and (6) “declining terms of trade” for countries that tied their currencies to the U.S. dollar.<sup>19</sup> Lane reduces these domestic causes to “financial fragility,” centering on excessive borrowing of short-term foreign capital, often for dubious “equity and real estate” ventures, and poor allocative decision making.<sup>20</sup>

The crisis also provided fertile ground for those seeking to make a political or ideological point about the nature of Asia’s economic development. Written as the crisis was beginning and published in the midst of it, for instance, Lingle’s *The Rise and Decline of the Asian Century* uses perceived weaknesses in the Asian Model as points of departure for a vigorous economic liberal manifesto. Lingle views East Asia’s economies as inherently fragile and in need of extensive political and economic liberalization.<sup>21</sup>

The sudden scholarly 20/20 economic hindsight should give pause. In light of this growing causal consensus, it is amazing that more observers did not see the crisis coming in 1997. Only a few observers seriously questioned the Asian development path prior to 1997, most notably Young and Krugman, though various media stories in late 1996 and early 1997 raised warning flags.<sup>22</sup> The near unanimity with which the supposedly state-led Asian Model of development was praised prior to 1997—by both economic liberals and economic nationalists—and then questioned or condemned thereafter, should make anyone cautious about predicting regional economic development. In truth, there never was a clear Asian model, and what existed was never universally successful. Factors behind high growth differed from country to country and always depended on favorable international markets and/or good relations with the U.S. and Japan. One wonders whether the same scholarly blindness could become manifest the next time an international financial crisis looms. While the exact conditions that fostered the crisis in 1997 are now absent from the region, the speed with which international lending to the region resumed, and the unevenness of reforms, show that dangers arising from volatile international financial markets and local governance failures still abound.

Two things are often forgotten in this blizzard of analysis. First is the key role of the state in fostering economic development in East Asia. The typical East Asian capitalist development state of the 1960s to 1980s was neither a *rentier* nor populist state, as in much of the rest of the developing world. Instead, through relatively careful control and management of national finances, manipulation of foreign exchange and access to technology, selective use of protectionist measures, and industrial targeting, states were able to forge strong export-oriented growth. With variations, this path was successfully followed by South Korea, Taiwan, Malaysia, and Thailand, and elements of it adapted in China. Where these states (minus China) got into trouble was in following U.S. advice and gradually downplaying these roles as they liberalized financial sec-

tors in the 1990s. In fact, the shifting role of the state may have been the key domestic variable in each country strongly impacted by the crisis.

The second forgotten fact is that the Asian crisis was but the latest in a series of international financial ups-and-downs in the post-Bretton Woods era. Much of the turbulence since 1973 has been caused by the instability of the U.S. dollar, which had been the bedrock of stability in the earlier period. During the 1970s, the dollar generally declined in value, in large part due to growing budget and trade deficits and the energy crises of 1973–1974 and 1979. It then rose dramatically in the early 1980s because of overspending during the Reagan administration, as U.S. trade deficits ballooned. Joint G-7 efforts talked down the dollar after the Plaza Agreement in 1985, and this helped much of Asia because their currencies' links to the dollar made their exporters competitive vis-à-vis high-yen Japanese companies. The Clinton administration at first pushed the dollar down even lower, then reversed itself and let it rise by half against the yen. The Asian countries could have saved themselves a lot of anguish by devaluing their currencies as the dollar rose, but stayed with the greenback for reasons of stability and prestige. All this occurred in conjunction with financial liberalization and the massive flow of foreign funds to "emerging markets," especially in Asia.<sup>23</sup> Accordingly, U.S. international financial policy and Asian domestic factors can be held jointly responsible for the crisis.

### Asian Reform Efforts

With the U.S. and Japan taking a relatively passive role in the crisis and its aftermath, the affected Asian states have had to confront their problems alone. The three countries hit worst by the crisis, Thailand, Indonesia, and South Korea, have received the most journalistic and scholarly attention. States in all three countries have made strenuous efforts to reform their political economic systems, either in line with IMF recommendations or on their own initiative. Because of differing regime capacities and economic conditions at the time the crisis hit, the efforts of each have varied enormously. This section considers actions of these and other key Asian nations affected by the crisis.

**Indonesia.** Indonesia's crisis started as a small run on the rupiah, and ended as a depression caused jointly by local mismanagement and inept IMF programs. Its problems were as much political as economic, and the general weakness of the Suharto, Habibie, and Wahid governments made the task of economic management all that more difficult. Conservative state fiscal and monetary policies up to mid-1997 were generally praised, but the confused response of the government to the crisis added to the severity of its impact. The first IMF package in the fall of 1997 did little to halt the slide of the rupiah, which the Fund considered more important than keeping the economy going, and the mandated fiscal

and monetary contraction probably accelerated the country's fall into recession. Worries about Suharto's health and the deterioration of the political situation probably intensified the currency's fall. A second package in January 1998 called for more sweeping reforms of trade and governance. The government did not see a real need for many of the reforms, and many remain unimplemented. The economy had basically stabilized by 1999 but has yet to fully recover.<sup>24</sup>

Since Suharto's downfall in 1998, the nation has been gradually coming apart. Always little more than a fragile confederation of disparate ethnic communities, the sprawling island nation was only held together by the successive Sukarno and Suharto authoritarian regimes. Bank reforms have been slow, and the government has been reluctant to liquidate failing financial institutions. Recent scandals have touched current president Wahid directly and, combined with continued weakness of the economy (not to mention the rupiah), call into question his leadership and political longevity.<sup>25</sup> Wahid has also shown a curious passivity in the face of mounting violence across the country. To avert resignation or removal from office, the president felt compelled to apologize publicly for his poor performance and to delegate much of his power to Vice President Megawati.<sup>26</sup> Given ongoing ethnic and separatist struggles in various parts of the nation, it is difficult to be sanguine about the nation's future. Perhaps the best the country can hope for, in order to retain its national integrity, is some sort of loosely organized federation with increased political autonomy, but degrading of central power would probably not bode well for long-term economic growth.

**Thailand.** Thailand is a middling case, between sick man Indonesia and the fast-recovering Korea. It was the first major country to succumb to the crisis, and its symptoms were archetypal: holding on to the U.S. dollar peg too long, unwisely defending its currency's value, pumping up real estate and local development projects with easy credit, along with declining competence of, and respect for, bureaucratic controls. The country began a democratic transition in 1992, but politicians made the mid-1990s Thai bubble worse through ill-considered local pork barrel projects in electoral constituencies. Thus, while failure of governance has never been as great a problem as in Indonesia, state industrial policy centered on leveraged development greatly contributed to the nation's growing problems.

An IMF rescue package of \$16.7 billion called for higher interest rates, brakes on the central bank's power to pump money into the economy, higher taxes, bank holidays for various financial institutions, and stricter terms for bad loans. Unlike Indonesia, the government cooperated fully with the IMF, and the package was fairly popular, since much confidence had been lost in the government. The Thai government has made extensive efforts to improve its economic management, but the government has struggled to pass legislation liberalizing bankruptcies and foreclosures.<sup>27</sup> While the Thai economy has been recovering since 1998, largely due to increased exports, poverty has soared, along with fiscal debt

needed to maintain the social safety net. Full recovery of the banks depends on whether the economy can continue growing.<sup>28</sup> The political climate has remained murky, as the Chuan government could maintain only a shaky six-party coalition. Recent elections have resulted in a landslide victory by the untested Tai Rak Tai Party. Party leader Thaksin Shinawatra, a wealthy businessman closely allied with the large companies that became heavily leveraged prior to 1997, won with extravagant populist promises of loans for small businesses and debt forgiveness for farmers. With unresolved ethics charges against him, Thaksin may not be able to lead the nation for long. Unconnected with the difficult decisions of post-1997 crisis management, the new government may now feel free to return to many of the pork barrel and free lending policies that got Thailand in trouble in the first place.<sup>29</sup>

**South Korea.** South Korea has been an international developmental star, so its seemingly sudden difficulties in 1997 came as a shock to many observers. There were two connected causal problems, and a third one caused by a monumental policy blunder. First, the *chaebol* conglomerates had overexpanded since the 1980s, and consequently were overleveraged. By 1996 seven of the top corporate giants were on the verge of bankruptcy, and all of these failed by 1998. Second, beginning about 1993, the country went on a short-term borrowing binge, by 1997 running up nearly \$92 billion that would have to be paid off in ninety days or less. Third, the Bank of Korea failed to learn from Thailand and foolishly defended the won from depreciation in October 1997.<sup>30</sup>

Seoul has undertaken perhaps the most sweeping of the region's economic and political reforms, yet the reforms have been uneven and much remains to be done. The government of Kim Dae Jung (DJ) has successfully served as mid-wife for new "rules of the game" followed by banks and the *chaebol* conglomerates. For the business world, the most notable of such changes have been: (1) financial transactions are more transparent and companies must reveal much more information than ever before; (2) the government has made no effort to rescue ailing corporations, especially large ones like Daewoo; (3) financial monitoring has become more autonomous; and (4) internal corporate governance has become more democratic, as small groups of company shareholders are now allowed to bring suits and challenge company actions.<sup>31</sup> Major efforts under DJ include curbs on lifetime employment, closing ailing banks and looking for foreign buyers, renegotiating financial arrangements between *chaebol* and their banks, and allowing big companies such as Daewoo to fail. Nevertheless, a sense that the reforms have been slow or have stalled has added to international worries about Korea's future. For instance, Moody's has called attention to huge losses by the major banks in 1999, and the three largest securities companies are all in the red, in spite of a large infusion of state funds.<sup>32</sup>

However, political reform has been distinctly limited, and involves more a change of attitude toward economic management than any actual change in

behavior. Most of the ingrained precrisis Korean political patterns remain in place: excessive parochialism and regionalism; lack of bipartisan trust and inability of the ruling and opposition parties to compromise on key legislation; paranoia and use of instruments of power against opponents; and few checks on the concentration of power in the presidency. Accordingly, Korea's democratization and economic reorganization are likely to be extended affairs. Recently, the DJ government has shifted its attention from economic management to its efforts to improve relations with North Korea, and by late 2001 all eyes will turn to the next presidential election. Thus, any additional economic or political reforms will probably be incremental, at best.

**The Philippines and Malaysia.** Other countries were differentially affected by the crisis. While the Philippines suffered a major setback after the attack on the peso, subsequent economic and political problems were not entirely related to the crisis. Its political difficulties were rooted in the uneasy transition to democracy since 1986, and its economy began to cool off before the events of 1997. The Philippine government has had a difficult time squelching Muslim insurgents in the south. Malaysia, unlike its hard-hit neighbors, alone managed to avoid an IMF bailout and its attached conditionality, and so had to make only minor policy adjustments, such as scaling back its budget and shelving some grandiose projects. Partially insulated from the problems that beset its neighbors, Malaysia nonetheless has been gripped by Mahathir's efforts to strengthen control over his UMNO party and prepare it for his approaching retirement. This has created major fissures in the UMNO organization and helped the rise of the Islamic fundamentalist Pas Party.<sup>33</sup>

**China.** As a continental economy with huge financial reserves and an isolated currency, China was never in any serious danger from the contagion. It combined a perceived prudent management of its fiscal, monetary, and foreign reserve policies with skillful support for international stabilization efforts. Nonetheless, China's ongoing difficulties in restructuring its state-owned enterprises (SOEs) and related nonperforming loans of its banking sector do not bode well for the future. China's heady ten-percent-plus growth has already dipped to about seven percent, and may well slow to between five and seven percent in the next two years. The restructuring process will probably entail additional major layoffs, which will add to the country's growing unemployment problems and potential for social unrest.

**ASEAN.** Finally, ASEAN, the regional grouping that had held much hope to become an Asian counterpart to the European Union, proved completely ineffectual in the crisis. Its failure to do anything substantial or helpful in Southeast Asia's most difficult hour will no doubt delay the organization's consolidation as a supranational entity on a par with the European Union, or even NAFTA. In fact, at this point it would not be a stretch to label ASEAN as essentially moribund.<sup>34</sup>

## The Future

One cannot easily predict the future political economic course of East Asia. Just as only a handful of commentators and analysts suspected something was wrong in the months leading up to the July 1997 reckoning, few today see any major problems on the horizon. The crisis is over, and Asia has recovered, nearly all news media accounts indicate. But is this really so? Has Asia resumed its place as the growth center of the world?

At least three factors should continue to give one pause. First, politics have become much more unstable throughout the region than at any time since the 1960s. The most worrisome signs of this are in Southeast Asia. Indonesia is in a state of slow collapse, with the Wahid government unable to assert effective control over either the economy or its restive regions, and the problem of communal violence becoming increasingly serious. Malaysia's ruling UMNO coalition has developed major fissures that could threaten its ability to rule the country when Mahathir retires. Thailand's fragile coalition government pushed through various reforms, but it has been replaced by a party dominated by many of the people who created the conditions underlying the crisis between 1992 and 1997.<sup>35</sup> The situation is much better in Northeast Asia, and this regional division creates its own worries that the Northeast will recover as the Southeast lags.<sup>36</sup> Taiwan recently carried off its first democratic transition, though Chen Shui Bian had a rocky first year as president, and South Korea found generally more competent and confident leadership under Kim Dae Jung than under either of his two predecessors. However, Japan and China grapple with basically the same full agenda that they confronted three years ago, and while their states have not been significantly weakened, neither seems to be able to get a handle on the difficult challenges they face.

Simultaneous policy sluggishness in Tokyo and Beijing may be the most troubling Asian phenomenon at the dawn of the twenty-first century. Japan and China are the most important economies of the region; should a more serious economic crisis infect the region, one wonders if their rulers will be up to the task of handling it. Both governments used to be viewed as among the most effective in the world. Tokyo bureaucrats' ability to stage-manage the remarkable postwar recovery and catch up with the West from the 1950s to the 1970s brought Japan unparalleled international respect. Similarly, the ability of Deng Xiaoping and his colleagues to master the early stages of the difficult transition from socialist to capitalist markets in the 1970s and 1980s dazzled the world. When the recent crisis hit, neither government was able to craft a comprehensive response. To be sure, Japan aided other countries as best it could, and China won plaudits for not devaluing its currency and maintaining fiscal spending, but it did little beyond its own borders. Meanwhile, there were widespread worries that neither country was able to deal well with its major structural problems.

A second factor is the continued fragility of the post-1997 recovery. While



South Korea's economy quickly returned to high growth, the other seriously affected countries did not see positive economic growth until 2000, and by late in the year recession warnings appeared in Indonesia, Thailand, and the Philippines.<sup>37</sup> Business failures, high unemployment, weak banks, and widespread poverty remain serious problems in Indonesia. Thailand and the Philippines have yet to return to their former growth levels.

The third factor is less tangible, but must not be ignored: the acceleration of social changes accompanying the crisis. Workers and consumers are generally less likely to buy into the former Asian development model, since its legitimacy has been seriously questioned. Already more individualistic and less cooperative before the onset of the crisis, they now have less reason to respond to the exhortations of either large corporations or governments. This may be a good thing if these societies use these more atomistic tendencies to light the fires of entrepreneurial activity and innovation—or it could be a bad thing if it decreases the sense of cooperation and community that helped build the Asian economies in the first place.

One may suggest at least five possible scenarios for the next five to ten years:

**Clear sailing.** Despite various routine political and predictable economic difficulties in the years ahead, the major Asian economies learn important lessons from the 1997 calamity, and so both governments and private actors become more prudent, cautious, and professional. As a result, governments from Washington to Jakarta work hard to avoid a repeat of the previous crisis. For its part, the U.S. administration drafts an action plan for future crises, to emphasize both cooperation with Japan and other regional players and maximum flexibility in international responses to Asian financial problems. The reforms instituted in the wake of the crisis make the Asian economies more resilient and better able to cope with globalization, thus helping their companies to become major world players. Indonesia manages to hold together as a nation, and its economic management gradually becomes more competent and predictable. Thailand continues on its slow but steady reform path. The Philippines returns to growth, in part buoyed by the general regional boom. South Korea slowly transforms its remaining *chaebol* from corporate dinosaurs to healthy, focused conglomerates. China begins to get control of its SOEs and attendant unemployment conundrum, and Japan begins the first steps toward restructuring its lumbering postwar economy.

**Muddling through.** Minor financial crises crop up from time to time, some worse than others, but the region manages to avoid a replay of the events of 1997–1998. The IMF continues as the lead institution for dealing with the mini-crises, with the U.S., Japan, and China continuing to play ambiguous and unco-

ordinated roles. America proceeds on its own in splendid isolation, while acting as a vacuum cleaner for much of the world's excess capital. All the while, U.S. policymakers continue pushing the Washington Consensus, even when other policy approaches clearly would better serve Asia's recovery. South Korea's economy continues to grow, but more unevenly and unsteadily than since 1998. China's growth continues to slacken, and she is only partially successful dealing with banking and SOE restructuring; Hong Kong's economy fluctuates (up several months, down several more for the next several years). Japan remains the growth laggard of the industrial world, its stagnation extending for the better part of the next decade, and so is only able to extend limited help to its neighbors. Most of Southeast Asia recovers economically by 2002, but in an uneven and unstable manner.

**Fragmentation.** All over Asia, economic lessons are taken from the crisis, and some countries perform better than others. While growth of the overall Asian economy is satisfactory, two problems cloud Asia's future. First is a growing division between Southeast and Northeast Asia. Most of the capital—and most of the growth—remain in the latter, while the former languishes. Thailand and Vietnam manage some growth, but they are exceptions. Southeast Asia's problems become increasingly political. Indonesia slowly fragments into several nations, with the most populous, the Java Confederation, becoming a hellish maelstrom of short-lived governments, communal violence, endemic poverty, and economic stagnation. Religious wars unlike any seen since the seventeenth century tear apart communities throughout the islands. These religious conflicts spread to Malaysia, the Philippines, and southern Thailand, dragging down governments there. Northeast Asia effectively delinks from Southeast Asia, directing its trade and investment toward North America and Europe. Asia's economic problems do not spread to other regions, but neither do Asia's lackluster indicators assist overall global growth.

**The *Titanic* revisited.** The current "recovery" of Asia is actually much like the first half hour or so after the big ship bumped the iceberg. Outwardly, there does not seem to be any major problem, and the ship seems strong and safe. Deep in the bowels of the vessel, however, the seawater is rushing in. Indonesia flies apart, its government incapable of leadership and its economy collapsing. Thailand is fragile and tips into recession, while the Philippines never recovers. South Korea's recovery peters out, while most of the major *chaebol* fail. Chinese growth slows to a crawl, multiplying her banking and SOE problems. Within two years, the vaunted Chinese miracle is no more, and there is little chance for positive growth on the horizon. Japan fails to shake its economic blues, and goes three years without a single quarter of growth. A severe, prolonged recession grips the region, turning governments inward and back to state-led economic development programs. The effect on other regions is fairly mild, as positive growth continues in the U.S., Western Europe, and Latin America.

**Financial Armageddon.** As in 1997, a seemingly minor event triggers falling dominos throughout the region. This time, the troubles begin in the Philippines and spread throughout Southeast Asia in six weeks. The IMF quickly exhausts its funds, and has no effect on the crisis. The Chinese economy falls into an inflationary recession, and in two months mass rioting in the streets follows. Within weeks, factional struggles sunder the leadership, the Army goes over to the demonstrators, and the Communists are replaced by a nonpartisan government of national unity. Meanwhile, Japan's main commercial banks fall one by one, and the GDP slumps eight percent. In a snap election, the LDP loses over half of its strength in the lower House of the Diet, and a weak, inexperienced Democratic Party coalition takes over. Its prospects are not bright. Now the ripples spread rapidly throughout the world. Within two more months, Russia, Brazil, Argentina, and Mexico default on their international debts, and there is little the IMF can do. Japan sells a large share of its U.S. Treasury bond holdings, and a panic sell-off in American securities markets precipitates a general crash throughout the world. In a few days, stock markets around the world have lost nearly sixty percent of their value. A world depression has begun.

Which scenario is most likely? Scholars often like to pick the "muddling through" kind of scenarios because they seem to accord best with reality—neither the millennium in the morning nor doomsday by evening. Given the roller-coaster ride of international finance in the 1990s, merely muddling through would be far too safe. More to the point, any of these scenarios is conceivable. While the countries in the region have been working hard to repair their political economies, much about the way Asians do business has not changed, and many reforms have been delayed or watered down. In Korea, for instance, the *chaebol* that still dominate the economy have done little to slim down their operations, and several received New Year's 2001 gifts of fresh government investment funds.<sup>38</sup> Korean banks are still shaky. Indonesian authorities have not broken up the big monopolies and conglomerates favored by Suharto, and much more needs to be done to liquidate bad bank loans. While political instability remains widespread and economies appear poised to sink again into recession, another economic calamity is still possible.

Internationally, the IMF maintains its basic, one-size-fits-all approach to financial problems, may not learn much from the recent crisis, and probably will deal with the next crisis in much the same way as the 1997–1998 disasters. America's free-market-loving Clinton administration and the headless bureaucracy that is Japan have given few signs of learning any significant lessons from the crisis. The new Bush administration intends to shift American policy away from the China-centered and economic-liberal Clinton approach to a multi-directional, politics-first attitude. Nonetheless, Bush and his chief advisors are definitely free traders and are unlikely to consider significant changes in the management of international finance. Despite much international discussion

since 1997, as yet there is no consensus for reforming the operations of international currency or financial markets. Even small reforms usually attract potent opposition, especially from the U.S. government and international financial institutions.

### **Recommendations**

Like most complex problems of the twentieth century, grappling with the issues surrounding the Asian financial crisis is a bit like untying the fabled Gordian knot. An impatient Alexander the Great could slash through the knot with his sword. For national and international financial systems, which are so integral to economic growth and development, such an approach may not be possible. Each strand of the knot may have to be untied separately, until the whole mass of rope can be sorted out.

The central difficulty is that there are several parallel baskets of issues that must be dealt with simultaneously. A first basket of issues concerns the proper relationship between the state and business. Dealing with this is critical to subsidiary issues such as domestic moral hazard, bank supervision, transparency, monopolies, and cronyism. So far, this is where the most reform has occurred. Many of the needed reforms were contained in the IMF conditions attached to the bailout packages. Forced on economically besieged, politically panicked states in 1997, they were not followed through and so are still incomplete. While inappropriate in the midst of the crisis, they are indispensable today for nations seeking to avoid a repeat of the recent disaster.

**Recommendation #1:** East Asian nations, including China and Japan, should continue to reform their political economic structures. South Korea needs to concentrate on thoroughly reforming its *chaebol* and banks, Thailand its banks, and Indonesia its economic coordination mechanisms and banks.

A related set of issues confronts democracy in Asia. Kim Dae Jung has repeatedly said that democratization and economic reform go hand-in-hand, and economic liberals such as Lingle suggest that politics must be liberalized as much as economic structures. Most of the countries that got into trouble were either nondemocratic, especially Indonesia, or had strong elements of nondemocratic decision making. Conservatives stress that it has been those nondemocratic governments that guided Asia through its “miracle” years and that it has been the tight state-business connections that made possible the industrial economies of the region.<sup>39</sup> Even democratic countries in the region often lack effective economic management, partly owing to weak bureaucratic capacity and partly to endemic corruption, factionalism, and inability to reach consensus. Thailand and

the Philippines are two of the clearest examples of this. Both countries have struggled to create democratic processes but still have not fully institutionalized them.

**Recommendation #2:** Asia cannot go back to the old, pre-1997 ways of doing business. Even in China, there is an accepted need for new political economic approaches. South Korea and Taiwan have shown that democracy can bolster the state's hand in economic management, while enhancing its legitimacy. More democratic and open economic structures will bring Asian countries into line with their Western and Japanese competitors. All nondemocratic or partially democratic countries should draw up and implement plans for gradual democratization of politics, economic decision making, and corporate governance. This will not be easy and will require an extended series of negotiations between governments and oppositions on the nature of national political economic "pacts," that is, agreements that outline the obligations and roles of major players in any future government. The extensive literature on democratic transitions can provide useful guides.

The third set of issues concerns how the international community confronts financial crises. This ostensibly focuses on the way the IMF bails out countries, especially the conditions it attaches to its assistance programs. It also concerns the role of the big economies (principally the U.S., Japan, and Western Europe, and regionally China) and their policymakers in ameliorating financial breakdowns.

**Recommendation #3:** The IMF is just as much in need of major reform as the Asian countries. It functions as an undemocratic organization largely dominated by the U.S. and the other large industrial countries. The Fund has largely forgotten its original mission of helping countries get over short-term problems and has become Calvinist preacher to the world, forcing everyone into drastic reform, whether ready or not. Accordingly, first, the institutional structure should be reformed to include more open, transparent decision making. Second, the IMF should study and use alternative conditionality that can help countries recover faster. Third, the U.S., Japan, China, and other Asian countries need to reach agreement—after careful study—on establishment of an Asian Monetary Fund (AMF). A reasonable first step is to set it up as a temporary agency with a limited mandate to help countries through short-term financial crises. If within five years it is deemed a failure, it can be terminated. If it has helped regional stability, it can be financially augmented and institutionally expanded.

The fourth group of issues centers on the roles of the U.S. and Japan in global financial crises. These two rich countries are responsible for about half of the global GDP, and Japan accounts for roughly two-thirds of the East Asian economy. Given their central position in the world economy and their ostensible status as Pacific military allies, their role in any future financial crisis will be critical. Curiously, considering the political and economic stakes in the 1997–1998 events, both countries showed surprisingly passive, self-interested responses—as if they could simply withdraw into their domestic economies and not worry about the crisis. That they did something may have helped avert financial Armageddon; that they did little or often made the wrong decisions fueled the crisis and made it worse as it gained momentum.

**Recommendation #4:** The U.S. and Japan have ample resources for financial contingency planning. So, first, they should set up working groups within the American Treasury Department and the Japanese Ministry of Finance (with direct lines to the White House and Prime Minister's office, respectively), charged with continual consultation and "war-gaming" for the next financial crisis. They should write up playbooks available for dealing with different kinds of crises, such as Latin American-style fiscal and macroeconomic management tangles, Russian failures of governance, and liquidity shortfalls cum dropping currencies in Mexico or East Asia. Second, the two Pacific partners should reach agreement on establishment of an Asian Monetary Fund. Third, medium term, they should work to coordinate policies concerning financial and trade liberalization policy in East Asia. Finally, long term, they should work closely with economic bureaucrats in East Asian countries to better control currency levels, amounts of short- and long-term foreign funds flowing into each country, and interest rates.

A final basket of issues involves the operations of international financial markets and their contribution to the development of economic crises. Virtually every observer recognizes that the changed nature of global currency and financial markets since the end of the Bretton Woods system in 1973 has completely changed the way that states and businesses raise and use money. It also increases the danger of rapid meltdowns in national markets that can spread like wildfire to neighboring countries. More than ever, international financial markets cry out for regulation in times of crisis, yet such regulation is virtually nonexistent.

**Recommendation #5:** Various good ideas floated in recent years need to be more carefully studied, such as requirements not to withdraw funds invested in a country for a certain period of time (e.g., six months); to levy a global tax (sometimes called a "Tobin tax") on international financial transactions; to temporarily suspend international transfers during finan-

cial crises; and to allow countries to temporarily delink from the international financial system to deal with financial crises by using currency control boards and other ad hoc measures. As with an AMF, it may be possible to use these mechanisms on a trial basis for three or five years. Alternatively, these ideas could be used in one region as a sort of pilot project. Global taxes collected on financial transactions could go directly to the IMF or future mini-IMFs to supplement their emergency funds. This would probably be the most responsible use of such a tax.

After careful consideration and pilot studies, the international community needs to reach a consensus on any new tools to be used. This will not be easy, given the widespread acceptance of the Washington Consensus and the reluctance of the G-7 economic powers to consider changes in the operations of the international financial system. Even a commitment to study these ideas officially will be hard to achieve. Perhaps a first step could be a round of rigorous private studies of these proposals, which could constitute a baseline for subsequent official efforts.

### **Conclusion**

The ship of Asian finance nearly sank in 1997. Though the bulkheads have been patched and the ship continues to float, the ocean is choppy and full of icebergs, large and small. Will the ship make it safely to port, or sink with all hands? The current conventional wisdom is that the Asian financial crisis is over, but this article makes plain that now is not a time for complacency. Asian states may be muddling through now, but economic and political reform efforts have largely come to a halt, and disturbing signs of a return to the practices that brought on the crisis have surfaced in the countries most seriously affected. The key domestic variable in the crisis was the shifting role of the state in the nations impacted by the crisis, while the most important international variable was the instability of the U.S. dollar during the years leading up to the crisis.

Beyond reforming domestic economies and political structures, the world should confront the unstable nature of global financial markets. Aside from reforming the Bretton Woods institutions and constructing a more flexible international monetary authority, the U.S. and Japan need to better coordinate their responses to future financial crises. Washington's reluctance to confront the crisis aggressively, combined with Tokyo's inability to get a handle on its chronic stagnation and tattered financial sector, undermined global confidence and left the IMF as a perhaps too effective firewall. Moreover, internationalization of financial markets has brought distinctly mixed blessings, as even staunch defenders of globalization often note. Various serious proposals have been put forward to deal with financial market volatility. These proposals need to be seriously examined and debated by the international community. Consensus and

compromise on them can lead to the creation of a better functioning regime for handling future international financial crises, both in Asia and around the world.

### Notes

<sup>1</sup> "Indonesia Awakes to the Post-Suharto Era," *The Economist* (23 May 1998): 25.

<sup>2</sup> Charles P. Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises* (New York: Wiley, 1996), pp. 186–87; Lester Thurow, *The Future of Capitalism: How Today's Economic Forces Shape Tomorrow's World* (New York: Morrow, 1996), pp. 232–41.

<sup>3</sup> "The IMF's Response to the Asian Crisis," International Monetary Fund, 17 Jan. 1999 ([www.imf.org/External/np/exr/facts/asia.htm](http://www.imf.org/External/np/exr/facts/asia.htm)).

<sup>4</sup> "Moral hazard," an economics concept, suggests that if people are guaranteed payments under certain conditions, this will change their behavior and may bring about those very conditions. For example, if a government provides loan guarantees to corporate borrowers, neither banks nor companies may be as careful as they normally would be with borrowed funds, and this could lead to a default. See John Black, *Oxford Dictionary of Economics* (Oxford: Oxford University Press, 1997), p. 309.

<sup>5</sup> Lawrence B. Krause, "The Economics and Politics of the Asian Financial Crisis of 1997–98," Council on Foreign Relations, c. Spring 1998 ([www.foreignrelations.org/public/pubs/crisis.html](http://www.foreignrelations.org/public/pubs/crisis.html)): 25–28.

<sup>6</sup> Jeffrey D. Sachs and Wing Thyee Woo, "The Asian Financial Crisis: What Happened, and What Is to Be Done," Harvard Institute for International Development and University of California at Davis, 21 Jan. 1999 ([www.rebuildasia.com/Articles/jeff1b.html](http://www.rebuildasia.com/Articles/jeff1b.html)): 1–8.

<sup>7</sup> Michael J. Hogan, *The Marshall Plan: America, Britain, and the Reconstruction of Western Europe, 1947–1952* (Cambridge: Cambridge University Press, 1987), pp. 26–53; Alan S. Milward, *The Reconstruction of Western Europe, 1945–51* (Berkeley: University of California Press, 1984), pp. 92–125.

<sup>8</sup> Robert Gilpin, *The Political Economy of International Relations* (Princeton: Princeton University Press, 1987), pp. 317–28; David N. Balaam and Michael Veseth, *Introduction to International Political Economy* (Upper Saddle River, N.J.: Prentice-Hall, 1996), pp. 160–66.

<sup>9</sup> "Export-Import Bank Offers \$1 Billion in Short-term Financing to Indonesia . . .," EX-IM Press Release, 10 Apr. 1998 ([www.usinfo.state.gov/regional/ea/asiafin/eximindo.htm](http://www.usinfo.state.gov/regional/ea/asiafin/eximindo.htm)); "Text: USIA News Release on Assistance to Asian Students," and "Asian Students to Receive Temporary Assistance from Business, Government, and Education Partnership," USIA Press Releases, 31 Mar. 1998 ([www.usinfo.state.gov/regional/ea/asiafin/students.htm](http://www.usinfo.state.gov/regional/ea/asiafin/students.htm)); "Fact Sheet: U.S. Humanitarian Assistance to Indonesia . . .," U.S. State Department, 24 Mar. 1998 ([www.usinfo.state.gov/regional/ea/asiafin/indoaid.htm](http://www.usinfo.state.gov/regional/ea/asiafin/indoaid.htm)); "Text: Commerce Announces Asian Financial Crisis Initiative . . .," Commerce Department Press Release, 23 Jan. 1998 ([www.uninfo.state.gov/regional/ea/asiafin/doc123.htm](http://www.uninfo.state.gov/regional/ea/asiafin/doc123.htm)); "USAID Announces an Additional \$35 million in Economic Recovery Assistance to Asia," USAID Press Release, 19 Nov. 1998 (<http://pdq.state.gov/archive/GlobalFinance.zip>).

<sup>10</sup> Tim Sharrock, "In Focus: Asian Financial Crisis," *Foreign Policy in Focus*, Nov.



1998 ([www.foreignpolicy-infocus.org/briefs/vol3/v3n36asia.html](http://www.foreignpolicy-infocus.org/briefs/vol3/v3n36asia.html)).

<sup>11</sup> James K. Galbraith, "The Crisis of Globalization," *Dissent* (Summer 1999): 12–16.

<sup>12</sup> David Richardson, "Asian Financial Crisis," Parliament of Australia Parliamentary Library, 29 June 1998 ([www.aph.gov.au/library/pubs/cib/1997-98/98cib23.htm](http://www.aph.gov.au/library/pubs/cib/1997-98/98cib23.htm)).

<sup>13</sup> Kindleberger, *Manias, Panics, and Crashes*, *passim*. Also, see Miles Kahler, ed., *Capital Flows and Financial Crises* (Ithaca, N.Y.: Cornell University Press, 1998); Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System* (Princeton: Princeton University Press, 1998); Robert Solomon, *Money on the Move* (Princeton: Princeton University Press, 1999); Benjamin J. Cohen, *The Geography of Money* (Ithaca, N.Y.: Cornell University Press, 2000); and Susan Strange, *Mad Money: When Markets Outgrow Governments* (Ann Arbor: University of Michigan Press, 1998).

<sup>14</sup> "East Asian Financial Crisis Leads to Tumultuous Year in Emerging Markets," *The Robinson Rojas Archive* ([www.rrojasdatabank.org/wbeafc.htm](http://www.rrojasdatabank.org/wbeafc.htm)); "The World Financial Crisis," *The New York Times* ([www.nytimes.com/library/financial/index-global-fin-crisis.html](http://www.nytimes.com/library/financial/index-global-fin-crisis.html)).

<sup>15</sup> Callum Henderson, *Asia Falling: Making Sense of the Asian Crisis and Its Aftermath* (New York: Business Week Books [McGraw-Hill], 1998), *passim*.

<sup>16</sup> Karl D. Jackson, "Introduction: The Roots of the Crisis," in Karl D. Jackson, ed., *Asian Contagion: The Causes and Consequences of a Financial Crisis* (Boulder, Colo.: Westview Press, 1999), pp. 1–24.

<sup>17</sup> Krause, "Economics and Politics of the Asian Financial Crisis," pp. 1–12.

<sup>18</sup> Morris Goldstein, "The Asian Financial Crisis," International Economic Policy Briefs by Institute for International Economics, Mar. 1998 ([www.iie.com/NEWSLETR/news98-1.htm](http://www.iie.com/NEWSLETR/news98-1.htm)).

<sup>19</sup> Richard P. Cronin, "Asian Financial Crisis: An Analysis of U.S. Foreign Policy Interests and Options," CRS Report for Congress, 28 Jan. 1998 ([www.fas.org/man/crs/crs-asia.htm](http://www.fas.org/man/crs/crs-asia.htm)).

<sup>20</sup> Timothy Lane, "The Asian Financial Crisis: What Have We Learned?" *Finance and Development* (IMF quarterly magazine), Sept. 1999 ([www.imf.org/external/pubs/ft/fandd/1999/09/lane.htm](http://www.imf.org/external/pubs/ft/fandd/1999/09/lane.htm)).

<sup>21</sup> Christopher Lingle, *The Rise & Decline of the Asian Century: False Starts on the Path to the Global Millenium* (Hong Kong: Asia 2000 Limited, 1998), *passim*.

<sup>22</sup> See Alwyn Young, "The Tyranny of Numbers: Confronting the Statistical Realities of the East Asian Growth Experience," *The Quarterly Journal of Economics* (Aug. 1995); and Paul Krugman, "The Myth of Asia's Miracle," *Foreign Affairs* (Nov./Dec. 1994): 62–78. Among the pessimistic news media accounts in early 1997 were: "Melt-down in Seoul," *Business Week* (10 Feb. 1997): 14–15; "From Bad to Grim in Bangkok," *Business Week* (17 Feb. 1997): 17; "Asia's Bad Banks," *Business Week* (24 Feb. 1997): 18–19; "One Tired Tiger" (24 Mar. 1997): 16–17; "A Mexico-like Morass in South Korea?" *Business Week* (5 May 1997): 19; "Suharto's Dilemma," *Business Week* (19 May 1997): 16–17.

<sup>23</sup> Henderson, *Asia Falling*, pp. 9–57.

<sup>24</sup> Krause, "Economics and Politics of the Asian Financial Crisis," pp. 16–20; Ross H. McLeod, "Indonesia's Crisis and Future Prospects," in Karl D. Jackson, ed., *Asian Contagion: The Causes and Consequences of a Financial Crisis* (Boulder, Col.: Westview Press, 1999), pp. 209–40.

<sup>25</sup> "Fraying at the Edges," *Far Eastern Economic Review* (25 May 2000): 16; "Saving

the Rupiah," *Far Eastern Economic Review* (8 June 2000): 74; "Ring of Scandal," *Far Eastern Economic Review* (25 June 2000): 24–25.

<sup>26</sup> "Collision Course," *Far Eastern Economic Review* (3 Aug. 2000): 20–21; "Reinventing Democracy," *Far Eastern Economic Review* (24 Aug. 2000): 24–25.

<sup>27</sup> Krause, "Economics and Politics of the Asian Financial Crisis," pp. 11–16; "The Faltering Front-runner," *The Economist* (12 Dec. 1998): 31; "The Next Test," *The Economist* (3 July 1999): 24.

<sup>28</sup> "Only the Rich," *Far Eastern Economic Review* (15 June 2000): 26–28.

<sup>29</sup> See "Unchecked, Unbalanced," *Far Eastern Economic Review* (7 Sept. 2000): 16–20; "Thailand Incorporated," *Far Eastern Economic Review* (18 Jan. 2001): 17–18.

<sup>30</sup> Krause, "Economics and Politics of the Asian Financial Crisis," pp. 20–24.

<sup>31</sup> Comments by Shin Geon-Chol, at Association of Japan Business Studies Conference, Fujisawa, Japan, 10 June 2000; Heather Smith, "Structural Reform and Macroeconomic Policy in Korea," Korea Economy Briefing Papers, Asia Pacific Press, The Australian National University.

<sup>32</sup> "Economic Policy Directions for 1999," Economic Policy Bureau, Korean Ministry of Finance and Economy, 30 Dec. 1998 ([http://www.mofe.go.kr/ENGLISH/ef\\_n.html](http://www.mofe.go.kr/ENGLISH/ef_n.html)); "Agreement for the Restructuring of the Top 5 Chaebol," MOFE, 11 Dec. 1998 ([http://210.204.208.3/kiiep/imf.nsf/webview3\\_4/](http://210.204.208.3/kiiep/imf.nsf/webview3_4/)); "Progress of Strengthening Prudential Supervision & Regulations," MOFE, 17 Dec. 1998 ([http://210.204.208.3/kiiep/imf.nsf/webview3\\_2/](http://210.204.208.3/kiiep/imf.nsf/webview3_2/)); "Work in Progress," *Far Eastern Economic Review* (8 June 2000): 70–71.

<sup>33</sup> "Divided We Fall," *Far Eastern Economic Review* (21 Sept. 2000): 32–36.

<sup>34</sup> See "Ties That Bind," *Far Eastern Economic Review* (10 Aug. 2000): 22.

<sup>35</sup> "Old Boys' Reunion," *Far Eastern Economic Review* (18 Jan. 2001): 20.

<sup>36</sup> "Asia's New Fissure," *Far Eastern Economic Review* (29 June 2000): 14–16.

<sup>37</sup> See *Asia 2001 Yearbook* (*Far Eastern Economic Review*), pp. 130–31, 186–87, 211–212.

<sup>38</sup> "So Long, Corporate Reform," *Business Week* (22 Jan. 2001): 16–17.

<sup>39</sup> See "Democracy in Asia," *The Economist* (19 Sept. 1998): 19.